YOUR MONEY

Opt for short-term debt funds as an alternative to FDs

These funds carry low risk and should be able to beat the returns from fixed deposits

DEBT FUND

	RETURN (%)			
Fund category	**1-week**	**1-month**	**3-month**	**1-year**
Liquid	0.13	0.54	1.66	7.51
Ultra short-term	0.27	0.46	1.90	8.65
Short-term	0.61	0.13	2.24	10.13
Credit Opportunities	0.66	0.20	2.35	10.79
Income	1.14	-0.54	2.57	12.45
Dynamic bond	1.43	-0.80	3.19	14.23
Gilt short-term	0.62	-0.02	2.46	11.80
Gilt medium-and long-term	1.82	-1.04	3.64	16.72

Source: Value Research

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With interest rates in fixed deposits (FDs) in banks declining, an option before FD investors is to look at debt funds, which carry low risk.

The interest rate on the one- and two-year FDs of the State Bank of India today stands at 7.05 per cent. But with banks continuing to cut lending rates (IDBI and State Bank of Travancore cut them last Friday), fixed-deposit rates could fall further, given that liquidity in the banking system is likely to remain in surplus for some time. In such a situation, one option before FD investors is to go for debt fund options, which carry low risk. While they can't give you "fixed" returns, some categories can provide higher returns than FDs with minimal risk.

Among debt funds, liquid and ultra short-term funds are those that don't carry duration risk. If a fixed-income investor is likely to need money in the next one year, these are the categories he should look at.

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Liquid funds invest in paper whose average maturity does not exceed 91 days. Over the past one year, these funds have given an average return of 7.50 per cent. Even in the future, their returns should be able to match the average returns from fixed deposits.

Ultra short-term debt funds invest in paper whose average maturity does not exceed one year. These funds have given a return of 8.65 per cent over the past one year. However, these interest rates may not stay. "As interest rates within the economy come down, the returns from these products will also come down," says Deepesh Raghaw, founder, Personalfinanceplan.in.

Nonetheless, ultra short-term debt funds should be able to outperform FDs. "They should be able to give you at least a 100-basis-point higher return than the average FD rate," says Rajeev Radhakrishnan, head of fixed income, SBI Mutual Fund.

One advantage of investing in these funds is that if interest rates begin to rise, the returns from these funds will adjust upward. "Bank FD rates will go up with a lag but the rate transmission in the capital markets is instantaneous," Radhakrishnan said.

Investors who do not need their money for three years may opt for short-term debt funds, whose average maturity does not exceed three years. But they are not entirely free of interest-rate risk: When rates move up, these funds could show negative returns (as has happened over the past month). These funds have given a return of 9.81 per cent over the past one year. Their advantage, however, lies in their tax treatment. If you invest in them for more than three years, they get taxed at 20 per cent with the indexation benefit.

"Even if you get a pre-tax return of 8 per cent from them, you could still end up with a post-tax return of around 7.5 per cent or more, depending on the inflation rate," Raghaw said.

When choosing a fund from one of these categories, investors should look for funds with a low expense ratio. They should also check the quality of the securities in their portfolios. "Selecting a fund from these categories based purely on returns would be a mistake since some funds generate higher returns by taking higher credit risk," said Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisers. Fund size is another important criterion. A large portion of the money in these funds comes from institutional investors. It is advisable to be in one of the larger-sized funds so that withdrawals by a few institutional investors at the same time does not put the fund under redemption pressure. Finally, consult fund ratings to make the right choice.